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# FAILED BANKS

## FDIC's Asset Liquidation Operations



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# Introduction

This report provides information on the efforts of the Federal Deposit Insurance Corporation (FDIC) to liquidate assets acquired from failed or assisted banks. FDIC plays a central role in maintaining public confidence in the U.S. banking system by insuring bank deposits up to \$100,000 against bank failures and acting as receiver for failed banks. When a bank fails, the FDIC insurance fund is used to pay off insured deposits or to arrange for the assumption of deposits by a financially sound bank. FDIC, as receiver for the failed bank, acquires some or all of its assets to liquidate. FDIC also offers open bank assistance by providing cash and other forms of assistance to prevent a bank's failure; assets may be acquired in such transactions as well. Liquidation is the process whereby FDIC manages and disposes of acquired assets, obtaining cash to pay FDIC and other creditors of a failed bank or FDIC alone in the case of an assisted bank.

During the 1980s, FDIC has handled the greatest number of insured bank failures in its history. Almost 700 banks had failed as of June 30, 1988, compared to a total of 702 from 1934, the year FDIC began operations during the Great Depression, through 1979. During that 46-year period, annual failures averaged about 15, with a high of 84. In 1987 alone there were 184 failures and 19 banks were assisted. Failures in 1988 have continued at a high level, and FDIC expects the number to approximate the 1987 total.

Recent failures have resulted in an extraordinary increase in the number and book value<sup>1</sup> of assets<sup>2</sup> acquired by FDIC to liquidate. As of March 31, 1988, FDIC was managing for liquidation some 177,895 individual assets from 691 failed or assisted banks. The book value of these assets totaled about \$8.6 billion.<sup>3</sup>

FDIC liquidates assets held in its receiver and corporate capacity. When a state-chartered insured bank fails, a receiver is appointed according to

<sup>1</sup>"Book value," as used in this report, is the dollar value of assets as they were carried on the books of failed or assisted banks at the date of acquisition by FDIC. For loans, it includes the remaining principal balance and, where applicable, amounts that have been charged off by the failed bank and similar adjustments.

<sup>2</sup>"Assets," as used in this report, are those items acquired by FDIC from failed or assisted banks that are categorized as "assets in liquidation" in FDIC's liquidation accounting system. They include such items as installment loans, commercial loans, real estate mortgages, and owned real estate.

<sup>3</sup>These figures exclude the assets acquired from Continental Illinois National Bank and Trust Company of Chicago and the First National Bank and Trust of Oklahoma. These assets are handled by banks under service agreements with FDIC rather than directly by FDIC, as is the case with all other assets. (See page 20.)

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state law; typically FDIC is the appointed receiver.<sup>4</sup> When a national bank is closed, its charterer—the Comptroller of the Currency (OCC)—appoints FDIC as receiver, as specified in the Federal Deposit Insurance Act (12 U.S.C. 1821). As receiver, FDIC has a fiduciary responsibility to repay debts of the failed bank. To do this, it must marshal all assets, determine the amount owed to each creditor of the bank, and assume the failed bank's financial obligations to all creditors and stockholders. It is also responsible for managing and liquidating the assets owned by the failed bank's estate, investing the proceeds after expenses are paid, and distributing court-approved dividends<sup>5</sup> obtained from the liquidation of assets. FDIC also obtains assets in its corporate capacity, that is, the assets are bought by the insurance fund from (1) receiverships, so that they may be terminated, and (2) assisted banks.

Since failures began rising in the early 1980s, a higher percentage of the insurance fund's assets has become tied up in receivables from receiverships, including loans and property once held by failed banks, or assets acquired as a part of assistance transactions, rather than invested in assets that are more liquid, such as U.S. Treasury securities. Net receivables and notes now constitute about 26 percent of the fund's assets, up from 7.6 percent in 1980. (See table 1.3 on p. 18.) FDIC officials have expressed a desire to maintain the liquidity of the fund in order to have the flexibility to deal efficiently with failing institutions and to maintain public confidence in the insurance fund. The more funds are tied up in outstanding loans and property, the less money is immediately available for use by the fund. Several steps have been taken in recent years to obtain cash from assets more quickly or minimize the impact on the insurance fund. For example, in 1987, FDIC began selling the entire operations of a failed bank, referred to as whole-bank sales. (See pp. 12 and 13.)

In the 1980s, FDIC also began providing assistance to banks that were in danger of failing. The purpose was to prevent the closing of an insured

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<sup>4</sup>The Federal Deposit Insurance Act (12 U.S.C. 1811-1832) specifies that FDIC may act as receiver for a failed bank.

<sup>5</sup>Dividends are distributions of income in excess of expenses to creditors and stockholders to satisfy claims against the receivership estate. Typically, FDIC attempts to make the first dividend payment to creditors no later than 9 to 12 months after the bank's closure. Subsequently, dividends are to be paid whenever funds available for such payment equal 10 percent of total proven and unproven claims. The order for distribution of proceeds is typically (1) liquidation expenses, (2) FDIC-preferred claim for collection after closing, (3) loans from FDIC to the receivership for advance dividend payments, (4) common claimants, which includes FDIC for advanced funds, (5) interest to claimants, (6) subordinated debt, (7) preferred stockholders, and (8) common stockholders. (Source: Accounting for Receivership Liabilities, Division of Accounting and Corporate Services, FDIC, Jan. 1987.)

bank. In the 1981 to 1987 period, assistance was provided to 47 banks. (See p. 16.) Although this method cannot always be used, the FDIC Act provides that when it is used, assistance must be proven to be less costly to the insurance fund than arranging purchase and assumption or deposit payoff/transfer transactions. (12 U.S.C. 1823) An exception is made, however, when the continued operation of the failing bank is considered essential to provide adequate banking services to the community or when severe financial conditions exist that may threaten a significant number of financial institutions

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## FDIC and Division of Liquidation Structure

FDIC has four divisions. The Division of Liquidation has primary responsibility for handling insured bank failures. Its responsibilities include (1) the prompt payment of a failed bank's insured deposits or the expeditious transfer of these deposits to a financially sound bank and (2) the liquidation of any assets under FDIC's control. The Division of Bank Supervision is responsible for bank examinations and supervision, key components of FDIC's efforts to promote and maintain the safety and soundness of banks and to secure compliance with laws and regulations. The Division of Accounting and Corporate Services and the Legal Division are primarily service organizations that provide the necessary accounting and legal support to accomplish FDIC's mission.

The Division of Liquidation is managed by a director and three associate directors in Washington, D.C. The associate director for credit is responsible for overseeing all credit-related decisions and the general disposition of acquired assets from failed banks. The associate director for operations is responsible for overseeing the paying of insured depositors, managing the closing of banks, and generally overseeing division operations at regional and subregional offices. The associate director for administration is primarily responsible for overseeing automated financial systems, general record keeping, and for special projects. Analogous positions are generally found in regional offices. (See pp. 21 to 24 for a discussion of the regional and subregional offices.)

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## How FDIC Handles Failed Banks and Acquires Assets

FDIC relies on two basic types of transactions to handle bank failures: purchase and assumption transactions and deposit pay-offs or deposit transfers. In 1986, there were 98 purchase and assumption transactions, 21 deposit payoffs, and 19 deposit transfers. The 1987 totals were 114, 11, and 40, respectively. More recently, FDIC has been trying to sell the entire failed bank's assets in transactions it refers to as "whole-bank" purchase and assumption transactions

Since the mid-1960s, FDIC has preferred to use the purchase and assumption method in which a financially sound bank assumes the failed bank's depositor liabilities and some or all of its assets.<sup>6</sup> FDIC then advances funds to the assuming bank to cover the difference between the book value of the assets the bank acquires and the liabilities it assumes, adjusted by any premium (cash payment) offered by the assuming bank, and retains any assets the acquiring bank does not purchase. (FDIC generally also assumes responsibility for assets subsequently returned by the acquiring bank under a "repurchase agreement," which allows assets to be returned ("put back") within a specified period of time—typically ranging from 30 to 90 days.) We were told by a senior Division of Liquidation official that this method is preferred because it (1) provides full protection to depositors, (2) minimizes the disruption of banking services to the community, and (3) reduces the extent of losses to FDIC.

In whole-bank transactions, a new form of the purchase and assumption transaction, FDIC encourages the acquiring bank to purchase the maximum possible volume of the failed bank's assets. This departs from the practice of having the receiver retain poorer quality assets. Prospective bidders are invited to analyze all of a failing bank's assets and to submit bids to purchase those assets "as is" on a discounted basis. According to FDIC officials, this type of sale has two advantages: (1) it softens the impact on the local community because the failing bank's entire customer base continues to be serviced locally by an ongoing financial institution and (2) it lessens the growth in assets held by FDIC for liquidation. In 1987, 19 whole-bank transactions were consummated.

In a deposit payoff, FDIC as receiver pays off all deposits up to the legal limit, now \$100,000, and retains all assets and all other liabilities. Deposits in excess of the limit are usually treated as other general debts of the bank, and their owners share proportionately in the proceeds from liquidating the bank's assets.<sup>7</sup> In a deposit transfer, FDIC makes the insured deposits available to their owners by transferring the accounts to an existing financially sound bank or a bank newly formed solely for paying insured depositors. A deposit transfer is preferred over a payoff because depositors are not inconvenienced. For example, a depositor can immediately do business at the assuming bank. This method was first used in 1983 and has been used more frequently in recent years.

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<sup>6</sup>FDIC solicits bids from qualified potential purchasers in advance of the actual closing.

<sup>7</sup>In state bank receiverships with a statutory depositor preference provision, all depositors are paid ahead of common claimants.

The lack of interest on the part of a financially sound institution in assuming some of a failed bank's assets often stems from the fact that it is located in a state that does not allow banks to have branches or from the suspected involvement of fraud in the failure, in which case many assets may be worthless or disputed. FDIC officials say in such instances a deposit payoff or transfer is used instead.

FDIC may also acquire assets through a type of transaction known as a corporate purchase. FDIC may find it advantageous to purchase assets, in its corporate capacity, directly from an open bank that is in danger of failing or from the estate of a bank that has been put into receivership in order to terminate the receivership. As of March 31, 1988, assets on FDIC's books acquired through this method and managed by the Division of Liquidation amounted to about \$197 million (about 2 percent of the book value of acquired assets so managed). Assets acquired by FDIC as receiver for failed banks and in a corporate capacity are, in general, liquidated the same way.

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## Types of Assets Acquired by FDIC

The types of assets to be liquidated in FDIC's total inventory of about \$11 billion as of December 31, 1987, are shown in figure 1.1. Commercial loans make up 61.2 percent of the total, and mortgages another 16.2 percent. Installment loans, such as car loans, constitute another 3.7 percent. Some 5.4 percent of the total is composed of owned real estate.

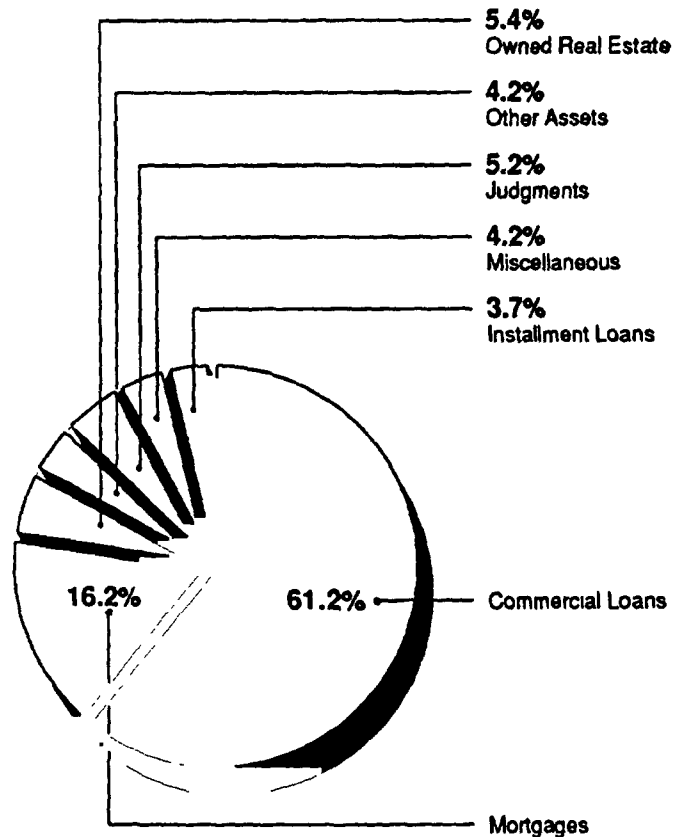
As a result of its liquidation activities, FDIC has had interest in a variety of properties, including oil tankers, tuna boats, taxicab fleets, art objects, and various forms of real estate, including a horse-training facility.

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## How Assets Are Liquidated

At a bank's closing, many of the FDIC staff present are assigned to control, balance, and inventory all assets. Assets acquired by FDIC are transferred to FDIC's inventory after the initial accounting. As receiver, FDIC first encourages all debtors to refinance their obligations at other institutions. If they can not or do not, FDIC designs a plan of payment, which adheres to the terms of the debtor's obligation. If this is not possible, programs (workouts) that extend the terms of repayment may be arranged, provided the debtor is able to furnish evidence that the debt cannot be repaid according to the original terms and/or furnish additional collateral security.

**Figure 1.1: Type of Assets Held by FDIC  
as of December 31, 1987**



Notes Includes assets from Continental Illinois National Bank and Trust and First National Bank and Trust of Oklahoma

Total is greater than 100 percent due to rounding

Source FDIC All Banks Account Trial Balance for Liquidation Accounting, December 31 1987

When debtors cannot pay even if payments are stretched out, FDIC may compromise—modify the original debt—with the debtor for less than the amount owed. Where debtors fail to cooperate, appropriate legal action can be taken to collect. For example, once the decision is made to



enforce collection, FDIC can act to foreclose, take possession of the collateral, and sell the loan collateral. A flowchart detailing the liquidation process is provided in appendix II.

While FDIC liquidates assets mostly through its own staff, it also contracts with outside attorneys, appraisers, consultants, and others to provide specialized support services. FDIC's 1988 budget for outside services is \$114 million (18.3 percent of the agency's total costs). About 92 percent of the budgeted costs for outside services are for the Legal Division (about \$54 million) and the Division of Liquidation (about \$50 million). Outside legal services used specifically in connection with liquidating assets are included in the amount allocated to the Legal Division. The Division of Liquidation also budgeted \$17.5 million for appraisal fees and \$9.4 million for real estate commissions.

## Increase in Failed and Assisted Banks and Assets Acquired by FDIC

The increase in the number of insured bank failures and assistance transactions since 1980 is shown in table 1.1, as is the total book value of assets associated with the failed or assisted banks. (All these assets were not acquired by FDIC.)

**Table 1.1: Number of Failed or Assisted Banks Since 1980**

Dollars in millions

Year	Number of bank failures	Number of banks assisted	Value of failed bank assets <sup>a</sup>	Value of assisted bank assets <sup>a</sup>
1980	10	0	\$236	\$0
1981	7	3	104	4,755
1982	33	9	1,416	10,216
1983	45	3	4,137	2,890
1984	78	1 <sup>b</sup>	2,761	515
1985	116	4	2,845	5,896
1986	138	7	6,992	719
1987	184	19	6,851	2,516
	<b>611</b>	<b>46</b>	<b>\$25,342</b>	<b>\$27,507</b>

<sup>a</sup>Value is the dollar value of all assets as they were carried on the books of the banks at the date of failure or assistance—not just those acquired by FDIC to liquidate

<sup>b</sup>Excludes Continental Illinois National Bank and Trust, which held assets with a book value of \$41.5 billion as of March 31, 1984, before the start of the financial assistance program

Source: FDIC, 1982-1987 Annual Reports

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Adjusted original book value and estimated gross cash collections categories do not add up to the total because of rounding

Source: Developed by GAO from data provided by FDIC using the Financial Information System and Estimated Cash Recovery Report Number 3. Timing of Estimated Cash Recoveries as of September 30, 1987.

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## Timing of Recoveries

FDIC officials told us that generally it should take an average of 5 years to liquidate the assets of a failed bank, with the majority of assets disposed during the first 3 years. Data developed from the 63 liquidations and from the Omaha Consolidated Office appear to support the belief that a large portion of the book value is reduced during the initial 3 years of liquidation; however, the data show that it takes an average of 12 years to terminate receiverships.

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## Timing of Liquidations for 63 Failed Banks

Information obtained on the 63 failed banks allowed us to estimate the extent that failed bank assets were liquidated within the first 2 years of liquidation. As of September 1987, these liquidations had been under FDIC management for at least 15 months and as long as 21 months, with an average of 17 months. We found that, on the average, 40 percent of the adjusted original book value of acquired assets from the 63 liquidations was reduced within these first 15 to 21 months of liquidation. Conversely, about 60 percent of the book value was still remaining to be liquidated by FDIC.

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## Timing of Liquidations at Omaha

At the Omaha Consolidated Office, we were able to obtain data on the book value of assets over the life of each liquidation handled by the office. This was possible because all bank failures then handled by the Omaha office were relatively new—none had failed before June 1984. Also, managers at the Omaha office tracked balances by asset type for internal information purposes. Similar data from the Denver and Oklahoma City consolidated offices were not available; these offices handled 49 liquidations dating back to 1979 and 55 liquidations dating back to 1982, respectively.

As of December 31, 1987, the Omaha Consolidated Office was handling 35 liquidations, which consisted of 29 purchase and assumptions and 6 deposit payoffs. We focused on the 27 liquidations that were at least 1

year old<sup>a</sup> and developed an aging schedule to determine the extent the number and book value of assets were reduced after 1 to 2 years of liquidation, after 2 to 3 years of liquidation, and after 3 to 3.5 years of liquidation. The results of this analysis are shown in table 4.2.

**Table 4.2: Reduction in Number and Book Value of Assets<sup>a</sup> at Omaha Consolidated Office**

Dollars in millions	Period of time in liquidation status		
	1-2 yrs.	2-3 yrs.	3-3.5 yrs.
Number of liquidations	27	21	9
Average age (months)	17.3	28.4	39.5
Original number of assets retained by FDIC <sup>a</sup>	12,061	10,000	5,496
Number of assets remaining after 1-2 years, 2-3 years, and 3-3.5 years in liquidation	5,048	2,487	730
Percent reduction in number of assets	58.2%	75.1%	86.7%
Original book value of assets retained by FDIC <sup>a</sup>	\$253.0	\$171.8	\$86.7
Asset book value remaining after 1-2 years, 2-3 years, and 3-3.5 years in liquidation	\$148.7	\$74.6	\$26.0
Percent reduction in asset book value	41.2%	56.6%	70.0%

<sup>a</sup>The original values do not consider any subsequent repurchases, discovered assets, or other adjustments that may have been made to the liquidations' original inventory of assets because that information was not readily obtainable and would be too time-consuming to reconstruct, according to officials at the Omaha office. Making adjustments similar to those used in our analysis of the 63 liquidations (see table 4.1, p. 53), we found that the median adjustment was 33 percent. Thus, the reduction in book values noted in table 4.2 above may be understated, based on the assumption that additions to the original book values were about 33 percent, the above reductions in book value are underestimated by an average of 10 percent for the three periods.

Source: Number and book value of assets provided by the Omaha Consolidated Office.

## Projected Future Recovery From FDIC-Acquired Assets

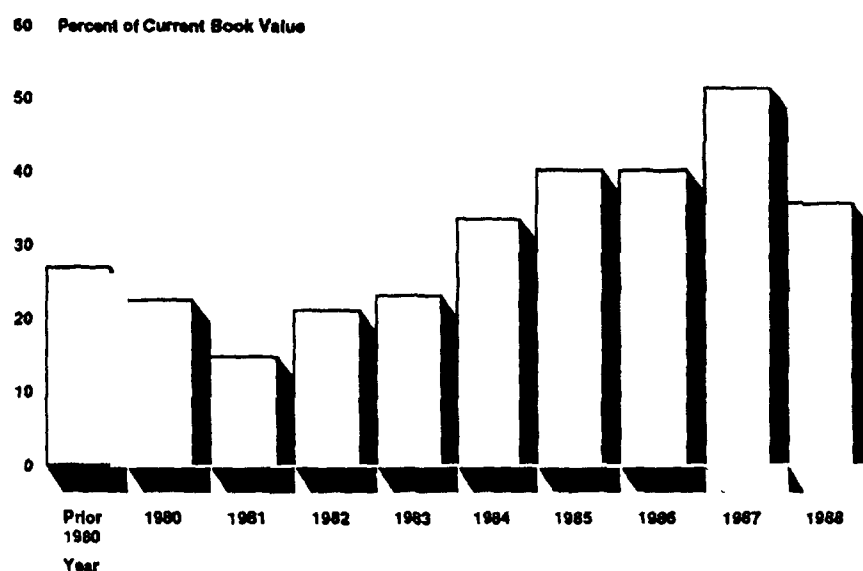
Two important questions that relate to the liquidity of the insurance fund are (1) what does FDIC expect to recover on the assets in its current inventory of acquired assets and (2) over what period of time are collections and recoveries expected to occur? We used the ECR data to determine the recovery rates for assets handled by FDIC for liquidation as of March 31, 1988. We found that gross collections were projected at almost 40 percent, on average, of the current book value. (It should be noted that any past collections on individual assets are not included in this percentage and estimated recoveries represent additional future collections.) For recently closed banks, no assets may have been collected on, or written off, yet. As expected, the numbers in figure 4.1 show that projected additional recoveries from assets of older failed or assisted

<sup>a</sup>We focused on liquidations that were at least 1 year old because additions, such as repurchases and discovered assets, to original book value generally made during the first year may offset collections for this initial period and result in negative recovery rates.

banks are generally lower than from assets of the more recently failed or assisted banks. The primary exception is for 25 of 46 banks which failed during the first quarter of 1988. The reason for this lower rate according to FDIC officials is that estimates made within the first 90 days of a receivership are preliminary estimates which tend to be conservative. For the 379 liquidations created from January 1986 through March 1988, recoveries were expected to be about 46 percent.

The March 1988 ECR data also showed that 77 percent of the total estimated collections would occur in the 2 years following liquidation. Between the 3rd year and 5th year of liquidation, 18 percent more of the estimated collections would be realized and the remaining 5 percent would be realized beyond the 5th year.

**Figure 4.1: Gross Future Projected Recovery Based on Year of Bank Failure Assets in Inventory as of March 1988**



Source: FDIC Estimated Cash Recovery Report Number 3: Timing of Estimated Cash Recoveries as of March 31, 1988.

## Termination of Receiverships

The life cycle of a bank liquidation—from failure of the bank to termination of the receivership—can vary considerably, depending primarily on the level of litigation involved and complexity of the assets. Before

recommending termination to the court, FDIC considers factors such as the extent to which it, as receiver, has repaid the insurance fund for advances; how much more it might recover, net of expenses, including judgments; and any outstanding claims against the liquidation. We were told by senior division management that one benchmark used to recommend termination is when the expense of continuing the liquidation is greater than the appraised value of the remaining assets.

Once the court agrees to the termination, the Division of Liquidation proceeds with termination procedures. FDIC as receiver pays uninsured depositors, the FDIC insurance fund and other creditors, their share of any cash remaining in the liquidation and removes the liquidation from FDIC books. (If any funds remain after all these claimants are paid, they are distributed to stockholders.)

As of March 31, 1988, 58 failed bank receiverships have been terminated since 1980. Almost 70 percent of the banks failed before 1977. The average life of a liquidation was almost 12 years, while the range was about 4.3 to 23 years. The percentage of terminations to bank failures occurring each year is shown in table 4.3. (Failures occurring before 1970 have all been terminated and are no longer carried in FDIC's inventory.)

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**Table 4.3: Terminations of Receiverships**

<b>Year</b>	<b>Number of failed banks</b>	<b>Number terminated<sup>a</sup></b>	<b>Percent terminated<sup>b</sup></b>
1965	9	9	100.0
1966	8	8	100.0
1967	4	4	100.0
1968	3	3	100.0
1969	9	9	100.0
1970	8	7	87.5
1971	6	5	83.3
1972	3	1	33.3
1973	6	6	100.0
1974	4	1	25.0
1975	14	10	71.4
1976	17	10	58.8
1977	6	3	50.0
1978	7	5	71.4
1979	10	6	60.0
1980	10	0	0.0
1981	7	2	28.6
1982	33	2	6.1
1983	45	1	2.2
1984	78	0	0.0
1985	116	0	0.0
1986	138	0	0.0
1987	184	0	0.0

<sup>a</sup>This column represents the number of bank failures in the given year which were terminated between the year of failure and March 31, 1988.

<sup>b</sup>This column represents the percentage of bank failures in the given year that were terminated as of March 31, 1988.

Source: FDIC, Estimated Cash Recovery Timing Report Number 3: Timing of Estimated Cash Recoveries by Consolidated Office, as of March 31, 1988, and Annual Reports for FDIC.

As of March 31, 1988, 27 failed banks were classified as being in termination status—that is, they were no longer active liquidations, their accounts were frozen and subsequent expenses were not allowed to be charged to their accounts. In some instances, a court action such as settlement of litigation was needed before the liquidation could be fully terminated.

## Summary

With the implementation of the FIS and ECR, FDIC now has the ability to assess its operations in terms of liquidation recoveries and timeliness. When LAMIS becomes operational, analysis of asset-specific performance,

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including recovery rates, on a national basis will be possible. FDIC officials have been reluctant to use recovery rates in their analyses of performance because they say the rates reflect not only the effectiveness of liquidation efforts but also the prevailing economic conditions and quality of assets being worked. We do not disagree.

Information on recovery rates, by liquidation or by asset type, for example, can be used as benchmarks that provide a relative measure of collections associated with assets being liquidated. Such data might be used to establish internal liquidation criteria and goals, as well as provide useful information to managers, giving them a basis for year-to-year comparisons, for example.